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Brazil: Struggle for Financial Stability Continues

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An Intelligence Assessment

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ALA 84-10035
April 1984

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An Intelligence Assessment

This paper was prepared by [redacted] 25X1
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It was coordinated with the Directorate of
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Secret
ALA 84-10035
April 1984

Declassified in Part - Sanitized Copy Approved for Release 2012/02/09 : CIA-RDP85S00317R000100030004-3

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Brazil: Struggle for Financial Stability Continues

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Key Judgments

Information available as of 15 March 1984 was used in this report.

Four major conclusions emerge from our forecasts of Brazilian economic performance in 1984 and the country's ability to comply with its IMF-backed stabilization program:

- Brasilia will again fail to make progress in the two key areas of dampening inflation and rebuilding foreign exchange reserves.
- Missed targets and a weakening commitment to stabilization in a preelection year probably will force Brazil to renegotiate its IMF agreement again and seek yet another $1-3 billion in commercial borrowings before yearend.
- The international financial community will most likely work out new targets and continued financial support, but there is about a 1-in-5 chance that adverse global and domestic conditions could lead to a Brazilian moratorium.
- Brazil's painful three-year recession will endure another year with gross domestic product declining 2 to 3 percent, unemployment rising to about 20 percent, and purchasing power continuing to plummet. 25X1

Brazil will be unable to squeeze the current account deficit sufficiently to generate substantial reserve replenishment because of growing protectionism against Brazilian manufactures and only a moderately favorable outlook for commodity exports and prices. Thus, Brazil will fall about $1 billion short of its $9 billion trade surplus target. Pursuit of economic adjustments in areas impacting on inflation will be weakened by continuing political liberalization, concern about choking the private sector, and only moderately expanded food supplies. We expect 130- to 150-percent inflation this year rather than the 100-percent target level. 25X1

If Brasilia falls substantially shorter of the mark than we calculate—if, for example, inflation declines insignificantly from the record 210 percent of last year—the IMF might react with demands for harsher austerity. In response, a prevailing mood probably would emerge in Brazil that retrenchment policies do not work. Consequently, the Figueiredo administration would most likely suspend further talks with the Fund and resort to a limited moratorium to pressure creditor banks for more generous debt relief. 25X1

[redacted]
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We see the beginnings of a sustained economic recovery in Brazil no sooner than 1985 or 1986, and this would require implementation of necessary policy reforms as well as continued favorable world economic conditions. Brazil will need to spur export growth and reduce its dependence on foreign borrowings by mobilizing greater domestic savings and shrinking public deficits in order to meet its large debt servicing and economic growth needs. [redacted] 25X1

Economic mismanagement or a setback in foreign conditions, however, could frustrate Brasilia's efforts to overcome its debt plight and promote a recovery. Should another global recession slow Brazil's exports, or another round of tight industrial country monetary policies raise interest rates, intense pressures would build for Brazil either to depress sharply economic activity or step up foreign borrowing to honor its debt obligations. Because neither course would probably be acceptable both to Brasilia and to foreign banks, there would be a substantially increased likelihood of a massive loan default or a debt repudiation. [redacted] 25X1

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Brazil's Phase II Financial Rescue Package

The IMF. *By gaining from the IMF a waiver of noncompliance and reaching agreement on new and revised performance criteria extending through the end of this year, Brazil is eligible to draw $1.6 billion in 1984 from its three-year Extended Fund Facility arranged in February 1983.* 25X1

The Private Banks. *Support from the IMF was contingent upon assistance from private banks. On 27 January 1984 some 670 commercial banks signed an agreement to provide Brazil a four-part syndicated loan package, including:*

- *A $6.5 billion medium-term loan, increasing participating bank exposure in Brazil by 11 percent. Bank terms are more generous than last year, stretching maturities an additional year to nine years, providing a five-year grace period, and offering a small interest-rate concession.*
- *A rescheduling of $5.3 billion in commercial loan payments that were due to mature in 1984.*
- *Continued access to $10.3 billion in short-term trade financing.*
- *Maintenance of $6 billion in interbank credit lines with Brazilian banks abroad.* 25X1

Foreign Governments. *The Western industrialized countries of the Paris Club agreed to:*

- *Provide $2.5 billion in loan guarantees from official export credit agencies. Although the United States has pledged to cover one-half of total, others—including the United Kingdom, France, West Germany, and Japan—still have not made specific commitments.*
- *Reschedule $3.8 billion in payments due by the end of the year on government-to-government and officially guaranteed credits. This total considerably exceeds the amount of rollover Brazil initially requested from Western creditor countries.* 25X1

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Brazil: Struggle for Financial Stability Continues [redacted]

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Introduction

The IMF's approval in November of a revised stabilization program eased Brazil's immediate financial bind but was only one step for the government in resolving the country's debt problems. Brazil must continue to pursue restrictive policies and implement painful economic reforms in the face of strong popular resistance. In addition, it will have to maintain the cooperation of international creditors to keep annual debt servicing burdens manageable. Failure to do this could lead to a government-imposed debt moratorium and the inevitable repercussions on the Brazilian economy and the international banking system. [redacted]

This paper reviews the evolution of Brazil's financial rescue package in 1983 and the difficulties Brazil encountered in adhering to it, analyzes the economic effectiveness and political costs of reinforced austerity that led to a revised IMF agreement, and assesses Brazilian prospects for overcoming the financial crisis and mounting an economic recovery. [redacted]

The Financial Rescue Package

A severe cutback in international lending and evaporating foreign exchange reserves led Brazil to conclude a financial relief agreement with the IMF in February 1983. The IMF offered Brazil $5.9 billion in financial support through 1985, while foreign banks—in cooperation with the Fund—promised to extend another $9.2 billion in new medium-term loans and debt refinancing. In return, Brazil promised to implement major economic adjustments and to meet ambitious fiscal, monetary, inflation, and balance-of-payments targets. [redacted]

By May, however, Brazil had fallen considerably short of most of its targets and forfeited claim to more than $3 billion in IMF and commercial bank loan payments scheduled over the remainder of 1983. In our view, Brazil's early troubles resulted from a combination of factors such as unrealistic goals and an unwillingness of a number of European and US regional banks to fulfill short-term credit pledges. In addition, Planning Minister Delfim appears to have moved too slowly in implementing monetary and fiscal discipline, resorting to a gradualist approach to minimize adverse political reaction. [redacted]

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[redacted]

Beginning in June, Brasilia implemented a series of new measures to slash the public deficit, including heavy additional cuts in price and credit subsidies and reductions in state enterprise spending. Finally, after the government passed through Congress the last important reform sought by the IMF—a wage restraint law—Brazil concluded a new agreement with the Fund and, subsequently, a new rescue package with creditor banks. [redacted]

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The 1983 Adjustments in Perspective

In retrospect, Brazil's IMF-backed adjustment program produced uneven results, with substantial progress on some fronts and less impressive impact in other areas. Simultaneously, the stabilization program produced, or aggravated, other structural problems that could seriously hamper the economy in years to come. [redacted]

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Achievements and Shortfalls. Brazil's economic policy performance last year was impressive in several areas even though the impact on inflation and foreign reserves was short of the desired result. According to government data, Brazil made major gains in its external accounts.[1] A $6.5 billion trade surplus, which

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[1] Brazilian data may somewhat overstate trade improvements. [redacted] press sources have reported incidents of underinvoicing imports and overinvoicing exports, selling into warehouse stocks, delaying import clearances, and making contraband imports. We have no reliable data, however, to estimate the magnitudes of these variables. [redacted]

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Returning to the IMF Track

Reinforcing Austerity. *Following the suspension of IMF assistance, Brazil's economic team persuaded President Figueiredo to adopt a more rigorous program to meet Fund objectives. During June and July 1983, the government:*

- *Eliminated petroleum subsidies by a 45-percent increase in oil product prices and slashed subsidies for wheat through a 100-percent price increase.*
- *Pared again its interest rate subsidies on loans for agriculture and exports.*
- *Signed two new decrees to cut 1983 state enterprise investment 25 percent below that of 1982 and to trim current spending that had previously been spared the budgetary knife.* [redacted]

Brasilia then moved to try to implement the last important reform sought by the IMF, delinking wage increases from inflation. In mid-July, after considerable controversy within the government, President Figueiredo provisionally enacted a decree restricting wage increases to 80 percent of inflation. The IMF refused to resume its support for Brazil, however, until the measure was made permanent law by surviving a 60-day congressional review. Popular opposition to the wage restraints swelled, however, and on 19 October the decree was defeated by the Brazilian Congress. [redacted]

Within a week, the government negotiated a compromise decree with the political opposition that it also hoped would satisfy the IMF. Under the new law, which ultimately won congressional approval in early November, wage restraint is milder (permitting wage hikes averaging 87 percent instead of 80 percent of inflation) and more progressive (using a sliding wage-adjustment scale). To offset much of the law's relative expansionary impact on the public deficit, the government increased personal and corporate income taxes and made deeper cuts in state enterprise fringe benefits. [redacted] 25X1

The Reconciliation. *In late November the IMF approved the revised stabilization program. Although the Fund and the foreign banks remained concerned by the modest progress in containing inflation and the less stringent wage restraint law enacted by Congress,* 25X1 [redacted] 25X1

Despite these qualms, the new IMF agreement reopened foreign financial flows. The IMF and commercial banks released more than $3 billion in frozen loans, which provided a temporary financial respite. Nearly all the money was quickly used to repay short-term bridge loans and to clear up interest arrears approaching 90 days overdue, the point at which loans from US banks can be declared nonperforming by US regulatory authorities. International lenders also began assembling another large package—centered on bank pledges of $6.5 billion in new loans as well as $5.3 billion of 1984 principal reschedulings—to meet Brazil's financing needs through 1984. [redacted] 25X1 25X1

enabled Brazil to reduce its current account deficit by more than half, surpassed the target. Reduced imports were primarily responsible, but increased export earnings also contributed after midyear as a result of government depreciation of the cruzeiro at a faster pace than domestic inflation—thereby strengthening the competitiveness of Brazilian goods. [redacted]

The government also tightened fiscal and monetary policies. Brasilia estimated that it may have saved some $2 billion in 1983 by cutting subsidies and another $2 billion by curtailing state enterprise investment. To facilitate this task, the administration established a new ministerial committee to monitor public-sector budgets. These actions, coupled with increases in taxes, probably permitted the government to reduce the operational public-sector deficit from 6.8 percent of GDP in 1982 to 2.7 percent in 1983.[2] According to 25X1

[2] The *operational deficit* refers to excess public-sector spending over revenues that is not the consequence of inflation adjustments to the stock of outstanding public debt. [redacted] 25X1

Table 1
Brazil: Balance of Payments

Billion US $

	1982	1983	1984		
			IMF Targets [a]	Less Stringent [b]	Less Favorable [c]
Current account balance	−16.3	−6.9	−6.0	−6.7	−8.0
Trade balance	0.8	6.5	9.0	8.3	7.5
Exports	20.2	22.0	25.0	24.8	24.0
Imports	19.4	15.5	16.0	16.5	16.5
Service balance, net	−17.1	−13.4	−15.0	−15.0	−15.5
Interest payments, net	11.4	9.6	10.6	10.6	11.1
Debt repayments	21.4	20.5	18.5	18.5	18.5
Longer term maturities	8.4	10.5	8.5	8.5	8.5
Short-term maturities	13.0	10.0	10.0	10.0	10.0
Gross foreign exchange requirements	37.7	27.4	24.5	25.5	26.5
Financed by					
Direct investment, net	2.5	1.3	0.7	0.7	0.5
Official and supplier credits	3.2	4.7	5.8	5.3	4.5
Loans					
Bridge operations	3.6	−3.6	0	0	0
Short-term credits and rollovers	12.0	10.0	9.0	9.0	9.0
Long-term credits	11.5	13.0	13.5	13.5	13.5
Others	4.9	2.0	−4.5	−3.0	−1.0

Alternatives:
[a] Brasilia complies with performance targets.
[b] Brasilia eases austerity slightly, increases imports, and cuts food exports.
[c] Foreign market interest rate conditions are moderately less favorable than expected.

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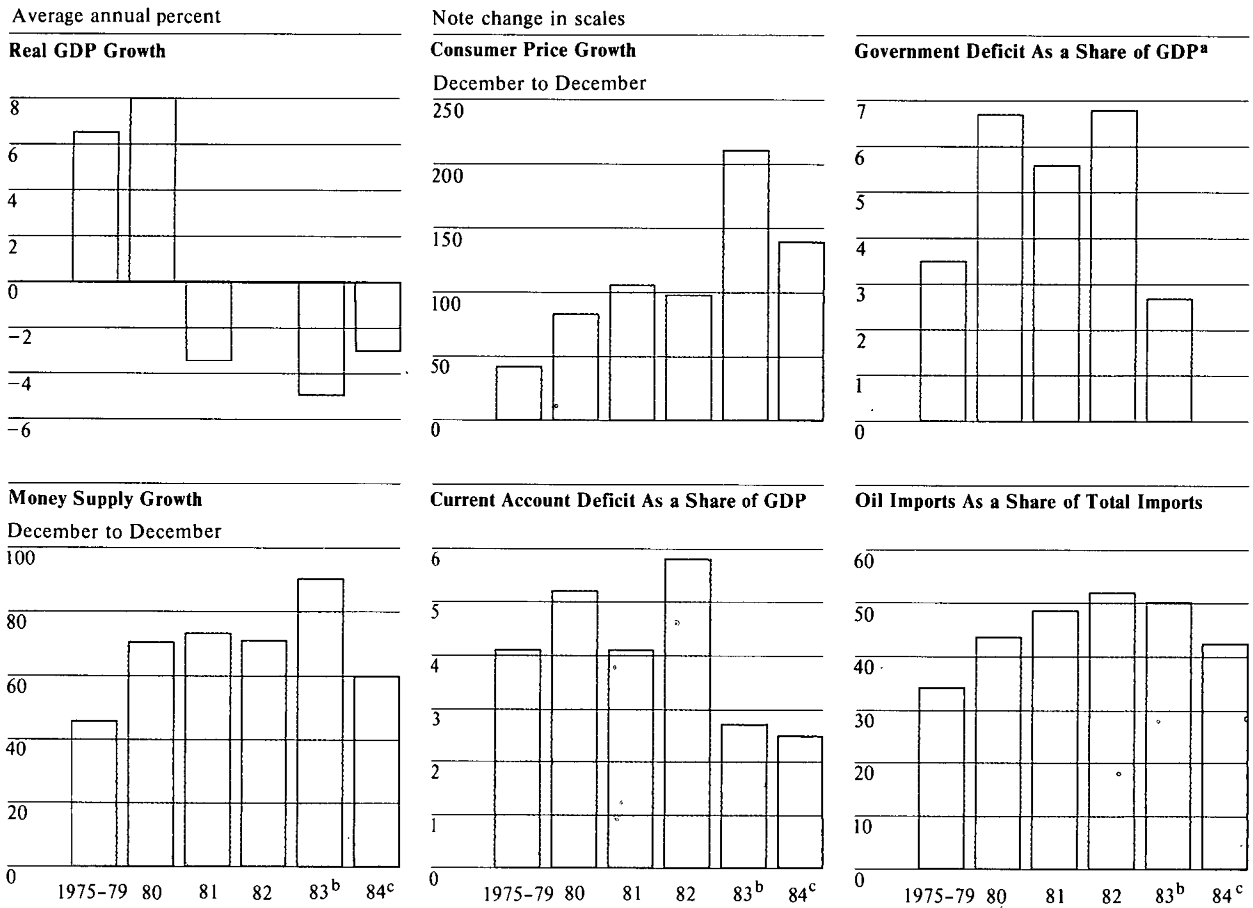
the US Embassy, the government also maintained a firm monetary policy. It held expansion of the monetary aggregates to less than 100 percent, close to the IMF's 1983 targets. Consistent with its new wage restraint policy, Brasilia in late December restricted a raise in federal employees' salaries to less than the past six months' rate of inflation, and took steps to assure that public corporations would do the same. 25X1

The austerity policies, however, did not push down the 1983 rate of inflation as intended. Inflation soared to over 200 percent, more than double the rate for 1982. Some of the adjustments themselves were partially responsible, including the rapid cruzeiro devaluations and the withdrawal of oil and wheat subsidies. Another important factor was the effect on food prices of major crop losses from drought and floods. Additionally, as prices spiraled upward, the velocity of money (the rate at which money in circulation changes hands) accelerated, offsetting some of the tightness in monetary policy. After peaking in October, inflation fell to single-digit monthly rates over the next three months; nonetheless, it is still too early to judge—because of uncertain prospects for agricultural production, credit, and price controls—that Brazil has turned the corner on price restraint. 25X1

Brazil: Economic Indicators, 1975-84



[a] Excludes inflation adjustments to value of outstanding public debt.
[b] Estimated.
[c] Projected.

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Nor did the reduced current account deficit alleviate Brazil's precarious foreign exchange position in 1983. Unexpected shortfalls in foreign bank funds and direct investment prevented Brazil from bolstering foreign exchange reserves beyond the yearend 1982 level, thereby leaving the country vulnerable to new external shocks. Foreign exchange reserves had actually fallen further through mid-1983 until centralized foreign exchange controls implemented in August and the December disbursements of suspended loans restored them to about the previous level.

Economic and Social Costs. Austerity, combined with sluggish demand abroad, had a severe impact on Brazil's economic activity. We estimate gross domestic product shrank 5 percent in 1983, Brazil's third successive no-growth year. Industrial production probably fell about 8 percent, according to the Sao Paulo Industrial Federation. Sales of capital and construction goods, electrical and electronics products, chemicals, and textiles plunged. Gross fixed investment slumped from a range of 21 to 23 percent of GDP between 1976 and 1980 to 18 percent in 1983.

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Both the public and private sectors shared in the decline. [redacted]

The government concentrated its efforts to cut public-sector spending on investment rather than the far larger operating budgets. The cuts fell mainly on nuclear energy, hydroelectricity, petroleum exploration, roads and ports, the steel sector, and the giant Carajas mining complex—all projects needed over the longer term to boost exports and trim dependence on oil imports. For example, Petrobras, the state-owned oil monopoly, pared its capital expenditures in 1983 by one-third. [redacted]

Private industrial activity and investment were undermined in several ways. Because the public sector had preferential access to the domestic banking system, the government's steps to restrain credit led to an especially severe shortage of funds in the private business community. Brasilia also has squeezed profits in private industry by holding price increases for some 300 manufactured goods to no more than 80 percent of the general rise in inflation. According to Embassy and press reports, centralized controls over the allocation of foreign exchange created problems for industrial importers of raw materials and intermediate goods. With rapid shifts in policy and accelerating inflation, press sources indicate businesses have increasingly shifted financial resources from new investment to speculative ventures. Parts of the private sector, such as electronics and textile manufacturers, survived largely through increased participation in the "underground" economy. Meanwhile, private business failures continued to mount. [redacted]

Brazil's lower and middle classes were hit hard by higher unemployment and real wage declines that cut into living standards. Recent private studies in Brazil's two largest cities indicate that for the average adult the minimum wage no longer is enough to buy food, much less other necessities. [redacted] Sao Paulo lost more than 200,000 manufacturing jobs in 1983, reducing even skilled and semiskilled workers to poverty. According to other published studies, the purchasing power of the middle class at the end of last year was one-half of what it had been three years earlier. Housing and retail trade statistics further confirm that the middle class is having to tighten its belt severely. [redacted]

New Challenges With a Revised IMF Accord

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To maintain the support of the IMF and other foreign creditors this year, Brazil must persevere with unpopular adjustment measures. With the help of policies negotiated with the IMF, Brasilia and the Fund agreed to try to reduce inflation to 100 percent and the current account deficit to $6 billion. The policy targets, which are ambitious and not easy to achieve even under the best of circumstances, include:

- Reducing the expansion of the money supply as well as the monetary base from about 90 percent in 1983 to only 50 percent in 1984. 25X1
- Cutting the public-sector borrowing requirements from 18.6 percent of GDP in 1983 to 11 percent in 1984. This requires eliminating last year's public-sector operational budget.
- Devaluing the cruzeiro against the US dollar at least as rapidly as the rise in Brazilian inflation.

In addition, the Brazilian Government has imposed on itself a $9 billion trade surplus target for 1984, which was accepted by the IMF. [redacted] 25X1

Potential Gains. Brazil will get some help in meeting adjustment targets from more favorable foreign and domestic economic factors—although, in our judgment, even these benefits will leave it short of its goals. Export earnings are likely to increase because of rising sales of manufactured products in response to economic recovery in foreign markets, higher prices for some commodities such as cocoa and orange juice, and a rebound in the production of other agricultural exports. Because of unusually poor weather conditions, agricultural production in 1983—as in 1982— 25X1 was considerably below the levels of the previous two years. Brazil also hopes that a boost in its oil production and steady world crude prices will enable it to trim $1-1.5 billion from its $7.8 billion of foreign oil purchases last year and hold total imports to $16 25X1 billion. Only then would the government be able to replace enough depleted raw materials, intermediate goods, and worn capital plant to achieve its industrial 25X1 export targets, according to the economic policy team. [redacted] 25X1

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Table 2
Brazil: Foreign Debt and Servicing Burden

	1980	1981	1982	1983 [a]
	Billion US $			
Total debt	**62.8**	**72.0**	**83.2**	**93.0**
Medium and long term	53.8	61.4	69.7	80.0
Short term	9.0	10.6	13.5	13.0
International reserves [b]	5.8	6.6	3.9	3.8
Debt service	13.0	16.9	19.8	20.1
Net interest	6.3	9.2	11.4	9.6
Amortization [c]	6.7	7.7	8.4	10.5
Exports	23.2	26.9	23.5	25.5
Goods	20.1	23.3	20.2	22.0
Commercial services	3.1	3.6	3.3	3.5
Gross domestic product	248.0	288.0	289.0	275.0
	Percent			
Short-term debt, as share of total debt	14.3	14.7	16.2	14.0
Total debt, as share of GDP	25.3	25.0	28.8	33.8
Debt service, as share of exports	56.0	62.8	84.3	78.8
Interest, as share of exports	27.2	34.2	48.5	37.6
Debt service, as share of reserves	224.1	256.1	507.7	528.9
Debt service, as share of GDP	5.2	5.9	6.9	7.3

[a] Estimated.
[b] Total reserves minus gold.
[c] Medium- and long-term debt.

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On the domestic side, the government has grounds for expecting a decelerating inflation. The measures now being enforced—raising new revenues and curbing expenditures—to cut back the public deficit will remove one important source of inflation. The current wage restraint law also should slow price increases. The government expects that increases in agricultural output based on greater planted acreage and resulting declines in food prices could be an additional force for undercutting inflation.

Offsetting Vulnerabilities. In the context of meeting IMF program goals, however, Brasilia is vulnerable to changes in Brazil's political environment and miscalculations in its economic assumptions. Notwithstanding Brazil's financial imperatives, the Figueiredo government is increasingly obliged under political liberalization to heed public opinion in formulating policy and to share decisionmaking authority with the Congress. In our opinion, the IMF accord will again require major sacrifices by the Brazilian people. A deepened recession during this election year risks stronger popular opposition to government policies, expressed—at the minimum—by more vocal public criticism of the IMF, and intensified lobbying by vested interests for economic concessions, demonstrations, and strikes. In such circumstances, the administration might be hard pressed to withstand both mounting popular pressures and an increasingly recalcitrant Congress insistent on modifying its policies.

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Plans for reaching trade targets could be frustrated on either the import or, especially, export side. Sustaining oil production at a level one-third above last year's 340,000-barrel-per-day average in order to restrain the overall import bill may be difficult in the face of cutbacks in 1983 and 1984 in the oil company's operating and investment budget. More likely, growing protectionism in industrialized and developing countries could disrupt Brazil's drive to export manufactured goods, and harvest shortfalls or sluggish commodity prices could limit foreign sales of traditional primary products. [redacted]

Domestic performance targets will be perhaps even more elusive. After subsiding substantially during the last two months of 1983, inflation surged again in January and February at an annual rate exceeding 200 percent. Brasilia cites fuel price increases, high preharvest food prices, and inflationary psychology as causes for the recent price leap. It continues to hope that sharply expanding food supplies resulting from a large agricultural harvest, together with continued restrictive government policies, will bring about a substantial dip in inflation by April. [redacted] however, the dry spell during the November-December planting period probably will set back harvest projections for at least some crops. Beyond this, the US Embassy has reported that many Brazilians already expect the monetary authorities to relinquish their efforts to restrain money growth to 50 percent to prevent strangulation of the private sector. [redacted]

Outlook for 1984

The US Embassy reports that the government's economic team and the IMF consider the performance targets achievable. We—and others in Brazil and the international financial community—are not so optimistic. Brasilia, in our view, would be unwilling to bear potentially high attendant political costs during the months leading up to the presidential election in January 1985. [redacted]

Rigorous adherence to the terms negotiated with the IMF perhaps could push inflation down near 100 percent but would probably lead to a GDP decline greater than 5 percent this year. The severe credit squeeze, high real interest rates, and large cuts in state enterprise budgets would guarantee continued declines in investment. Industrial output would almost surely plummet and an increasing number of private firms would be forced into bankruptcy. Unemployment, estimated by us to be about 15 percent in 1983, would rise to about 20 percent this year. Many additional workers would be forced to accept large cuts in their real wages to hold onto jobs. The resulting social strains would be likely to lead to more frequent mass demonstrations and perhaps mob violence. [redacted]

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Staying With the IMF . . . Barely. We believe the Figueiredo administration will continue to push key economic reforms, but not to the point of jeopardizing its major political objective, an orderly transfer of power to a civilian government.[3] To placate influential interest groups, the government will most likely try to mitigate further economic decline by loosening the squeeze on credit, wages, and imports. Although we expect government policies to take much of the steam out of price pressures, they probably will not cut inflation to less than 140 percent. Higher-than-projected inflation, in turn, will further hinder prospects for achieving the required target for public-sector borrowing. [redacted]

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Moreover, Brazil's current account deficit is likely to surpass its $6 billion ceiling. Export difficulties, especially, will probably make the government's goal of a $9 billion trade surplus unreachable. [redacted] soybean export goals alone probably will fall $500 million short because of weather-induced crop losses and a sluggish world price of beans. We believe such agricultural problems combined with growing foreign

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resistance to Brazilian imports and—possibly—an overly optimistic oil production projection will result in a $500 million to $1 billion cut in the country's trade surplus and a current account deficit little if any smaller than last year's $7 billion. [redacted]

For the year, the economy's decline would probably be held to 2 to 3 percent or less, a drop in output that would sustain social tensions but would be unlikely to trigger major turmoil. [redacted]

If Brazil demonstrates that it is making reasonable progress toward adjustment despite missing some performance targets, we believe—and the Brazilians are likely to calculate—that the IMF would be flexible. Although the Fund would undoubtedly request some tightening of performance targets and there might be brief interruptions in the flow of foreign funds, Brazil would probably proceed on its stabilization track with its backing from the IMF and foreign creditors intact. [redacted]

Brazil's failure to reduce substantially its current account deficit would require the government to seek additional bank loans. Unfulfilled assumptions concerning export demand and bank interest rates could also add to borrowing requirements. Some officials in Brasilia [redacted] already expect the government to petition the banks for another $1-3 billion by mid-1984 to cover payments shortfalls and foreign exchange reserve requirements for the year. We believe the major banks would respond positively as long as Brazil remained in the good graces of the IMF. [redacted]

Break With the IMF. Although we give the prospect less than a 20-percent probability, a convergence of adverse world economic trends, domestic political pressures, and economic policy setbacks could lead to a confrontation between Brasilia and the international financial community. If the IMF determines that the government has not made a sufficient, good-faith effort to comply with performance targets, it could insist on harsher austerity as the price for renewed financial assistance. The Figueiredo administration would almost certainly be unwilling to pay the political consequences. After midyear, because of the impending elections and change of government, both Brasilia and the IMF would become increasingly wary of a new round of negotiations. A stalemate would probably lead to a suspension of talks until 1985. [redacted]

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A break in IMF and foreign bank support probably would impel the Figueiredo administration to resort to a moratorium on all debt payments. The demands for a moratorium by those influential civilian groups that long have advocated a tougher Brazilian stand with international creditors would become extremely hard for the government to resist, especially during the months approaching the presidential election. The same unsatisfactory progress in controlling inflation or improving foreign exchange reserves that would prompt the IMF to seek even stronger retrenchment also would seem convincing proof to most Brazilians that adjustment policies are not only painful but do not work. Moreover, the argument that Brazilian adjustments alone are inadequate and that the banks must be pressured to assume a larger share of the burden probably will gain increased currency even in the Brazilian Government. [redacted]

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In the event of a break with the IMF, we believe the government probably would set the moratorium for a limited duration, perhaps 90 days, and attempt to persuade creditor banks to ease substantially the adjustment burden. Should the banks resist, however—and probably some major banks would—the negotiating positions of both sides could harden, threatening an estrangement between the government and foreign bankers. [redacted]

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If Brasilia were denied access to foreign funds, we believe it would respond by increasing domestic taxation, accelerating cruzeiro devaluations, and slashing imports. The reduced availability of imported oil and raw materials, however, would cause industrial and commercial output to plunge and domestic prices to surge. Although living standards would deteriorate badly, the implications for social unrest and further movement toward political liberalization are not as clearly negative in the short term as would be the case with rigorous adherence to the original adjustment targets. Indeed, a moratorium might dramatize Brazil's critical economic situation and make it easier to

obtain the domestic consensus needed to enforce austerity. Alternatively, Brasilia might turn to more expansionist domestic policies. In that event, however, hyperinflation would be likely to follow, accompanied by massive unemployment. Brazilians ultimately would have to endure significant hardships that could result in major social and political turmoil. [redacted]

Signs To Watch. Brazil's economic performance in the early months of this year will be critical to the government's willingness and ability to stay its present austerity course. A couple of successive months of single-digit price increases would support claims that the hyperinflationary cycle has been broken. A growing number of Brazilians might then concede that economic retrenchment was beginning to work and grudgingly acquiesce in these policies. Decelerating inflation would even benefit indexed wage earners by reducing or reversing cuts in their real pay. Furthermore, a strong export recovery would not only help exporters and importers but would also strengthen the country's general creditworthiness. On balance, we agree with the US Embassy that a continuation of these trends would open the way for a gradual reappearance of the Brazilians' traditional optimism. [redacted]

Alternatively, if Brasilia does not show significant progress in controlling inflation or bolstering its foreign exchange position early in the year, it will probably face rising pressure from Congress, the middle class, business, and labor for policy changes. Under these conditions, a nationalistic backlash could quickly develop. Some government officials already fear that these problems could precipitate another confrontation with the IMF and cause a new foreign exchange crisis by midyear. [redacted]

Beyond 1984

We are concerned about Brazil's longer run economic health. Debt servicing burdens will be large as repayments on loans contracted in the early 1980s are bunched in the second half of the decade. The rescheduling arrangements worked out with foreign creditors as part of the 1982 and 1983 rescue packages will add to this debt servicing load. At the same time, we expect Brazil's social and political tolerance for economic retrenchment to diminish as civilian politics come back into full play. Indeed, we believe that real growth of 4 percent over the second half of the 1980s will be needed to absorb new entrants into the labor force, bring down unemployment rates, and sustain an orderly and peaceful political liberalization process. Accordingly, the demand for imports will rise 25X1 substantially. [redacted]

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In attempting to meet its large debt servicing and economic growth needs, Brazil has few, if any, choices about what policies it must undertake. It must strengthen its ability to earn foreign exchange by spurring export growth and reduce its dependence on foreign borrowings. The government must implement economic and financial reforms aimed at revitalizing the private sector. In this vein, it must mobilize greater private domestic saving and keep a lid on public deficits. While the public sector needs to divest itself of financially burdensome enterprises and to cut 25X1 wasteful operating costs, it must resume its investments in key activities such as energy. [redacted] 25X1

[redacted] In addition to putting the economy on 25X1 more solid, self-sustaining footing, the above reforms will be essential to retain the confidence of foreign lenders in Brazil. [redacted] 25X1

The Payoffs. If Brasilia continues to implement necessary policy reforms, a favorable world economy could 25X1 give rise to a Brazilian recovery beginning in 1985. We also assume that the new civilian government that is to take office in March 1985 would maintain moderate economic policies and accept responsibility for honoring contracted debt servicing payments. By 25X1 our calculations, Brazil would be able to maintain 4-percent annual growth and meet its debt obligations if it could expand its exports an average 15 percent a year, induce banks to slowly reduce interest rates on its debt, and continue borrowing on the scale arranged for this year. [redacted] 25X1

US Interests

US commercial interests have been hit hard by Brazil's debt servicing crisis and recession. The profits of US banks, which hold nearly one-quarter of Brazil's total foreign debt, have declined because of the need to set aside reserves for potential loan losses and delays in debt servicing payments. The recession in Brazil is accompanied by an array of import and currency controls that deny the United States an important export market. US exports, which usually have captured the largest slice of Brazil's nonoil purchases, fell about 30 percent in the first nine months of 1983 compared with a year earlier, which itself was down from the 1981 level. US direct investors, holding about $7 billion of registered capital in Brazil, are taking losses and finding the investment climate increasingly less attractive because of depressed domestic markets, high local costs of credit, and increased government controls. Moreover, domestic US industries—steel, shoes, textiles—face competition from an influx of Brazilian exports. [redacted]

Although Brazil's critical foreign exchange situation has improved, we are concerned about loan defaults. Even a 90-day moratorium on debt servicing could cause major losses for a number of US banks, especially the large money center banks. In mid-1983 the $17 billion in long-term loans extended by the nine largest money center banks to Brazil amounted to 57 percent of the banks' aggregate capital base. A suspension of interest payments, for example, could wipe out close to one-half of the pretax income of Citibank, Brazil's largest commercial creditor. US regional banks, generally with less than 20 percent of their total capital invested there, are not nearly so deeply tied to Brazil, but would also be hurt. [redacted] 25X1

Even if Brasilia stays on the IMF track, however, we foresee increasing numbers of acrimonious bilateral commercial disputes. At a time when it is being pushed to achieve sharply larger trade surpluses, Brasilia complains that it is encountering growing protectionism to its exports in most industrialized countries, including the United States. Recently, the government has been concerned about a US drive, grounded on charges of Brazilian dumping, to slash imports of finished steel. According to the press, US and Brazilian trade officials are discussing the option of a voluntary Brazilian cutback in steel exports to avoid the imposition of duties or taxes that would raise the price of the steel more than 27 percent, but so far the negotiating positions of the two countries remain far apart. In 1983 finished steel sales to the United States earned over $200 million for Brazil, about 1 percent of total exports. [redacted]

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An Alternative Longer Term Outcome. The major imponderable is the global economic environment within which Brazil must operate. Recurrent economic slumps or tight monetary policies in the industrial countries or another major round of OPEC oil price increases would seriously set back Brazil's hopes for escaping its debt plight. With appreciably slower growth of export earnings and higher bank interest rates, Brazil could only honor its debt obligations in the second half of the 1980s by sharply depressing imports or by stepping up its foreign borrowings. [redacted] we believe a prolonged recession would be socially and politically intolerable. At the same time, foreign banks would probably steadfastly resist increasing their loan exposures in Brazil under these conditions. [redacted]

To avoid either massive loan defaults or a debt repudiation, the Brazilian Government and the banks would have to work out a mutually satisfactory arrangement to ease interest and repayment terms. In our view, from Brazil's perspective a major debt relief program would have to entail considerably lower interest rates and refinancings over a much longer time than eight or nine years. [redacted]

[redacted]

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